1 What is Auditing?

LEARNING OBJECTIVES

After studying the material in this chapter you should be able to:

- **explain the general nature of the audit function;**
- **distinguish between financial statement audits, compliance audits and operational audits;**
- **distinguish between external and internal audits;**
- **describe how auditing differs from accounting;**
- **explain why financial statement audits are necessary;**
- **discuss the benefits which arise from the external audit function for:**
  - **users of financial statements**
  - **the auditee (i.e. the entity whose financial statements are audited)**
  - **society as a whole.**

The following fundamental principle included in *The Auditor's Code* (APB, 1996) is particularly relevant to this chapter:

Fundamental principle of external auditing: ***Providing value***

1.1 INTRODUCTION

Under United Kingdom (UK) legislation, all companies with a turnover of £1 million or more,[1] and virtually all public sector entities, are required to produce annually, audited financial statements. The audits of these financial statements are big business. As shown in Figure 1.1, in 2000 the audit fees of just 10 of the largest companies listed on the London Stock Exchange amounted to nearly £63 million. It is therefore evident that the statutory audits of UK corporate entities as a whole involve a substantial amount of resources. But, what is an audit? Why are audits needed? Do they provide benefits commensurate with their cost?

We address these questions in this chapter. More specifically, we examine the nature of the audit function and distinguish between financial statement audits, compliance audits and operational audits, and also between external and internal audits. We consider the factors that make financial statement audits necessary and discuss their value for users of financial statements, for auditees (that is, the companies whose financial statements are audited), and for society as a whole.

Figure 1.1: Audit fees and non-audit fees paid to the auditors of 10 of the largest companies listed on the London Stock Exchange in 2000.[2]

Company	Audit fees £million	Non-audit fees paid to auditors £million	Auditor
BP plc	20.0	36.4	Ernst & Young
Vodafone Group plc	1.0	16.0	Deloitte & Touche
HSBC Holdings plc	18.4	10.7	KPMG
Astra Zeneca plc	2.3	9.9	KPMG
Royal Bank of Scotland plc	4.9	8.3	PricewaterhouseCoopers
Lloyds TSB plc	4.0	32.0	PricewaterhouseCoopers
Barclays Bank plc	4.6	27.0	PricewaterhouseCoopers
British Telecommunications plc	2.7	19.1	PricewaterhouseCoopers
Diageo plc	2.5	7.0	KPMG
Cable & Wireless plc	2.5	14.5	KPMG
Total	**£62.9**	**£180.9**	

Source: Relevant companies' annual reports

1 See footnote 7.

2 World-wide audit and non-audit fees paid by the relevant company.

1.2 WHAT IS AN AUDIT?

Anderson (1977) captured the essence of auditing when he stated:

> The practice of auditing commenced on the day that one individual assumed stewardship over another's property. In reporting on his stewardship, the accuracy and reliability of that information would have been subjected to some sort of critical review [i.e. an audit]. (p. 6)

The term 'audit' is derived from the Latin word meaning 'a hearing'. Auditing originated over 2,000 years ago when, firstly in Egypt, and subsequently in Greece, Rome and elsewhere, citizens (or, sometimes, slaves) entrusted with the collection and disbursement of public funds were required to present themselves publicly, before a responsible official (an auditor), to give an oral account of their handling of those funds.

In order to understand what an audit is and how it is conducted in the modern context, a definition is needed. A comprehensive definition of auditing with general application is as follows:

> Auditing is a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organisation making the assertions has been engaged, to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to users of the reports in which the assertions are made.[3]

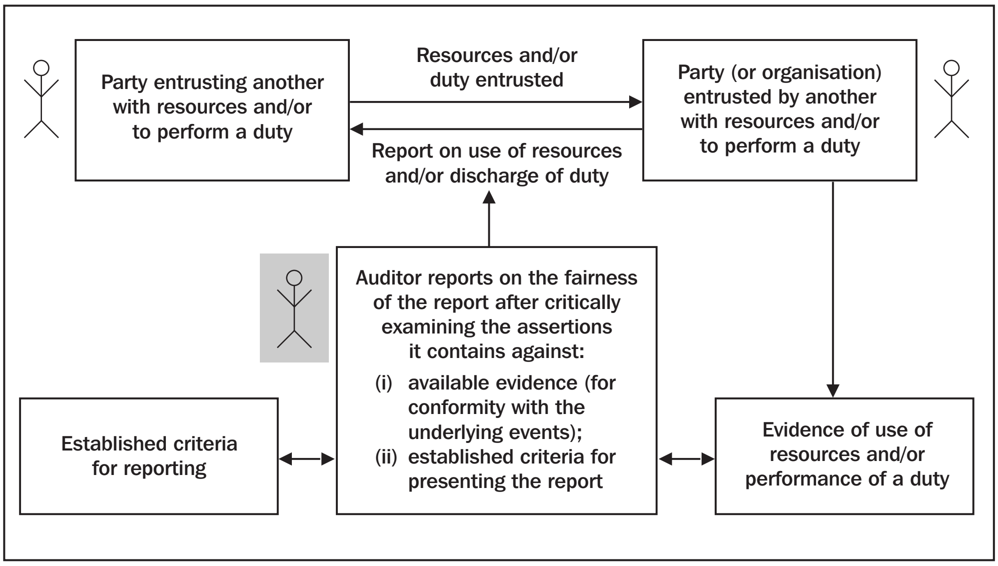
This definition conveys that:

- auditing proceeds by means of an ordered and structured series of steps;
- auditing primarily involves gathering and evaluating evidence. In pursuing this activity the auditor maintains an objective unbiased attitude of mind;
- the auditor critically examines assertions made by an individual or organisation about economic activities in which they have been engaged;
- the auditor assesses how closely these assertions conform to the 'set of rules' which govern how the individual or organisation is to act and/or report to others about the economic events which have occurred. This 'set of rules' comprises the established criteria which enable the auditor to evaluate whether the assertions represent the underlying events;
- the auditor communicates the results of this evaluation in a written report. The report is available to all users of the document(s) in which the assertions are made.

The major features of an audit are presented diagrammatically in Figure 1.2 below.

[3] Adapted from the definition provided by the American Accounting Association's (AAA) Committee on Basic Auditing Concepts (1973, p. 8).

Figure 1.2: Major features of an audit



1.3 TYPES OF AUDIT

Audits may be classified in various ways. They may, for instance, be categorised according to:

- the primary objective of the audit; or
- the primary beneficiaries of the audit.

1.3.1 Classification by primary audit objective

Based on primary audit objective, three main categories of audits may be recognised, namely:

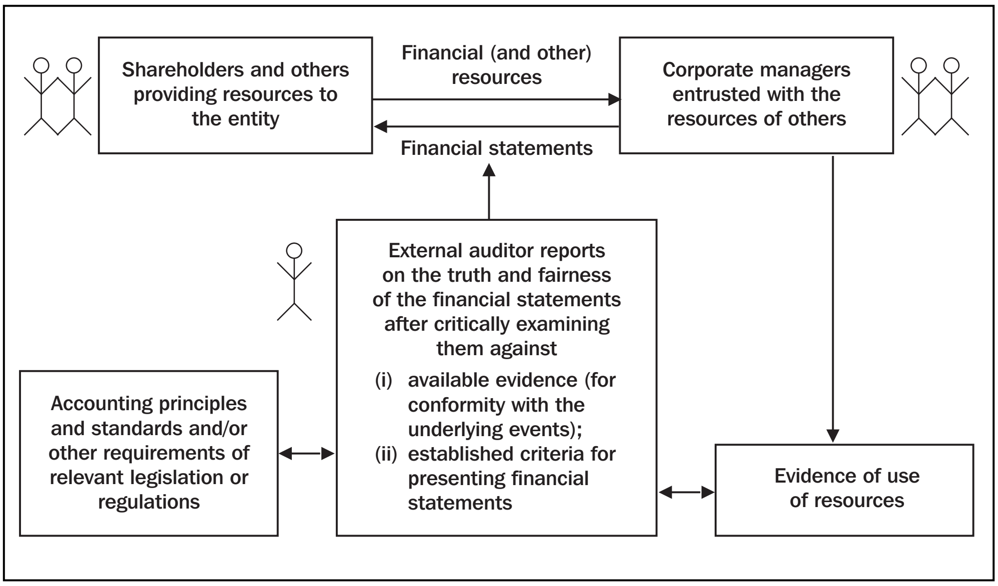
(i) Financial statement audits,
(ii) Compliance audits,
(iii) Operational audits.

(i) Financial statement audits

A financial statement audit is an examination of an entity's financial statements, which have been prepared by the entity's management/directors[4] for shareholders and other interested parties outside the entity, and of the

[4] In the Preface to this book it is noted that the term 'managers' is defined to mean a company's executive directors, non-executive directors, and non-director executives. Under the Companies Act 1985 (s.226) it is the responsibility of a company's directors to prepare the company's annual financial statements.

Figure 1.3: Major features of a financial statement audit



evidence supporting the information contained in those financial statements. It is conducted by a qualified, experienced professional,[5] who is independent of the entity, for the purpose of expressing an opinion on whether or not the financial statements provide a true and fair view of the entity's financial position and performance, and comply with relevant statutory and/or other regulatory requirements. The major features of a financial statement audit are presented in Figure 1.3.

Under section 226 of the Companies Act 1985, the directors of all companies are required to prepare annually, financial statements which include:

- a balance sheet, showing the entity's financial position (or 'state of affairs') as at the last day of the financial year;
- a profit and loss account, showing the results of the company's activities for the financial year.

Additionally, under section 235, auditors are required to report on these financial statements.[6] Thus, *prima facie*, all companies must, by law, subject their financial statements to an external audit. However, companies with a

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[5] The term 'an auditor' usually refers to an audit firm. Although one person is responsible for the audit and signs the audit report, the audit is usually conducted by an audit team.

[6] The statutory and regulatory requirements applying to the audited financial statements of companies are discussed in greater detail in Chapter 5.

turnover of not more than £1 million and a balance sheet total of not more than £1.4 million are exempt from a statutory audit.[7]

Companies taking advantage of the audit exemption, and also partnerships and sole traders (which do not need to appoint an auditor), may still require financial statement audits for specific purposes. For example, if one of these entities approaches a bank for a loan, the bank may require audited financial statements as a basis for deciding whether or not to grant the loan. Further, it is usual for clubs and societies to include in their constitution a requirement for their annual financial statements to be audited.

(ii) Compliance audits

The purpose of a compliance audit is to determine whether an individual or entity (the auditee) has acted (or is acting) in accordance with procedures or regulations established by an authority, such as the entity's management or a regulatory body. The audits are conducted by competent, experienced professionals (internal or external to the auditee) who are appointed by, and report to, the authority which set the procedures or regulations in place.

Examples of compliance audits include audits conducted by the Inland Revenue and by the Customs and Excise Department which are designed to ascertain whether individuals or organisations have complied with tax legislation or legislation governing imports and exports, as applicable. They also include audits conducted within companies, or other entities, to ascertain whether the entity's employees are complying with the system of internal control[8] established by management.

(iii) Operational audits

An operational audit involves a systematic examination and evaluation of an entity's operations which is conducted with a view to improving the efficiency and/or effectiveness of the entity. Such audits are usually initiated by the entity's management and are conducted by competent, experienced professionals (internal or external to the organisation) who report their findings to

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[7] In July 2001 the Company Law Review Steering Committee recommended that exemption from audit should be extended to companies that meet two of the following criteria: turnover of no more than £4.8 million, balance sheet total of no more than £2.4 million, no more than 50 employees.

The audit exemption is not available to a company if, at any time during the financial year, it was a public company, a banking or insurance company, an authorised person or appointed representative under the Financial Services Act 1986, a parent or subsidiary company (unless the group qualifies as a small group), or if members holding an aggregate of 10% or more of the nominal value of the company's issued shares request an audit (Companies Act 1985, s.249B).

[8] Internal control is discussed in Chapter 9.

management. An operational audit may apply to the organisation as a whole or to an identified segment thereof, such as a subsidiary, division or department. The objectives of the audit may be broad, for example, to improve the overall efficiency of the entity, or narrow and designed, for example, to solve a specific problem such as excessive staff turnover.[9]

1.3.2 Classification by primary audit beneficiaries

Based on primary audit beneficiaries (that is, those for whom the audit is conducted), audits may be classified as:

(i) external audits, or
(ii) internal audits.

(i) External audits

An external audit is an audit performed for parties external to the auditee. Experts, independent of the auditee and its personnel, conduct these audits in accordance with requirements which are defined by or on behalf of the parties for whose benefit the audit is conducted. Probably the best known, and most frequently performed, external audits are the statutory audits of companies' and public sector entities' financial statements (that is, financial statement audits). However, compliance audits conducted, for instance, by the Customs and Excise Department and the Inland Revenue, are also examples of external audits.

(ii) Internal audits

In contrast to external audits, internal audits are performed for parties (usually management) internal to the entity. They may be performed by employees of the entity itself or by personnel from an outside source (such as an accounting firm). However, in either case, the audit is conducted in accordance with management's requirements. These may be wide-ranging or narrowly-focused, and continuous (on-going) or one-off in nature. They may, for example, be as broad as investigating the appropriateness of, and level of compliance with, the organisation's system of internal control, or as narrow as examining the entity's policies and procedures for ensuring compliance with health and safety regulations.[10]

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[9] In public sector entities, broadly-based operational audits (or value for money audits) are generally required as part of the statutory audit function. However, additional more specific operational audits may also be initiated by the entity's management and conducted along the lines of those undertaken in private sector entities.

[10] Internal audits are discussed in Chapter 16.

1.3.3 Common characteristics of audits

It should be noted that, although different categories and types of audit may be recognised, all audits possess the same general characteristics. Whether they are financial statement, compliance or operational audits, and whether they are conducted for parties external or internal to the entity, they all involve:

- the systematic examination and evaluation of evidence which is undertaken to ascertain whether statements or actions by individuals or organisations comply with established criteria; and
- communication of the results of the examination, usually in a written report, to the party by whom, or on whose behalf, the auditor was appointed.

1.4 AUDITING VS ACCOUNTING

This book is primarily concerned with the external financial statement audits of companies and, unless indicated otherwise, when we refer to 'audit' or 'auditor', these terms should be understood in that context. However, before focusing attention on these audits we need to distinguish between auditing and accounting.

Accounting data, and the accounting systems which capture and process this data, provide the raw materials with which auditors work. In order to understand these systems, and the data they process, an auditor must first be a qualified accountant. However, the processes involved in auditing and accounting are different. Accounting is essentially a *creative* process which involves identifying, organising, summarising and communicating information about economic events. Auditing, on the other hand, is essentially a *critical* (or *evaluative*) process. It involves gathering and evaluating audit evidence and communicating conclusions based on this evidence about the fairness with which the communication resulting from the accounting process (that is, the financial statements) reflects the underlying economic events.

1.5 WHY ARE EXTERNAL FINANCIAL STATEMENT AUDITS NEEDED?

1.5.1 The need to communicate financial information

Over the last 160 or so years, business organisations have grown from owner-operated entities, which employed a handful of family members, to vast multinational companies staffed by thousands of employees. Such growth has been made possible by channelling financial resources from many thousands of small investors, through the financial markets and credit-granting institutions, to the growing companies.

As companies have grown in size, their management has passed from shareholder-owners to small groups of professional managers. Thus, company growth has been accompanied by the increasing separation of ownership interests and management functions. As a consequence, a need has arisen for company managers to report to the organisation's owners and other providers of funds such as banks and other lenders, on the financial aspects of their activities. Those receiving these reports (external financial statements) need assurance that they are reliable. They therefore wish to have the information in the reports 'checked out' or audited.

1.5.2 The need to have the communication examined

Three questions arise in relation to the 'checking out'of management's reports:
1. Why might the information in their reports not be reliable?
2. Why is it so important to the receivers of the reports that the information is reliable?
3. Why do the receivers of the reports not audit the information for themselves?

The answers to these questions may be found in four main factors, namely, a conflict of interests, consequences of error, remoteness, and complexity.

(i) Conflict of interests

A company's financial statements are prepared by its directors and these directors are essentially reporting on their own performance. Users of the financial statements want the statements to portray the company's financial performance, position and cash flows as accurately as possible. However, they perceive that the directors may bias their report so that it reflects favourably on their management of the company's affairs.

Thus, it can be seen that there is a potential conflict of interest between the preparers and users of the financial statements. The audit plays a vital role in helping to ensure that directors provide, and users are confident in receiving, information which is a fair representation of the company's financial affairs.

(ii) Consequences of error

If users of a company's external financial statements base their decisions on unreliable information, they may suffer serious financial loss as a result.

Therefore, before basing decisions on financial statement information, they wish to be assured that the information is reliable and 'safe' to act upon.

(iii) Remoteness

In general, as a consequence of legal, physical and economic factors, users of a company's external financial statements are not able to verify for themselves the reliability of the information contained in the financial statements. Even if, for example, they are major shareholders in a company, they have no legal right of access to the company's books and records. Further, they may be many miles distant from the company which prevents easy access to it, and/or they may not be able to afford the time and expense which would be involved in checking the information personally, should they have the legal right to do so.[11]

As a result of legal, physical and economic factors preventing users of external financial statements from examining personally the information provided by a company's directors, an independent party is needed to assess the reliability of the information on their behalf.

(iv) Complexity

As companies have grown in size, the volume of their transactions has increased. Further, especially in recent years, economic transactions, and the accounting systems which capture and process them, have become very complex. As a result of these changes, errors are more likely to creep into the accounting data and the resulting financial statements. Additionally, with the increasing complexity of transactions, accounting systems and financial statements, users of external financial statements are less able to evaluate the quality of the information for themselves. Therefore, there is a growing need for the financial statements to be examined by an independent qualified auditor, who has the necessary competence and expertise to understand the entity's business, its transactions and its accounting system.

1.6 BENEFITS DERIVED FROM EXTERNAL FINANCIAL STATEMENT AUDITS

In section 1.5 above, we noted that external financial statement audits are necessary because the ownership and management functions of companies

[11] However, it should be noted that many financial institutions, including pension funds, insurance companies and unit and investment trusts, which are significant shareholders of large UK companies, visit companies in which they have, or are considering, investment and question their managements. These institutions have considerable influence over the investee companies, especially if they are not performing adequately.

have become increasingly separated, and because of factors such as a potential conflict of interest between preparers and users of financial statements, and the inability of financial statement users to verify the information for themselves. In this section we consider the benefits derived from external financial statement audits by financial statement users, auditees, and society as a whole. These benefits are reflected in the fundamental principle of external auditing – *Providing value*:

> Auditors add to the reliability and quality of financial reporting [provided for external parties]; they [also] provide to directors and officers [of the auditee] constructive observations arising from the audit process; and thereby contribute to the effective operation of business, capital markets and the public sector. (APB, 1996)

1.6.1 Financial statement users

The value of an external audit for financial statement users is the credibility it gives to the financial information provided by the management of corporate entities. This credibility arises from three forms of control which an audit provides:

(i) *Preventive control:* Employees involved in the capture and processing of accounting data and/or the preparation of the entity's financial statements, who know their work will be subject to the scrutiny of an auditor, are likely to work more carefully than they would in the absence of an audit. It is probable that the extra care taken by employees prevents at least some errors from occurring.

(ii) *Detective control:* Even if employees in the auditee entity process the accounting data and prepare the financial statements carefully, errors may still occur. The auditor may detect these errors during the audit and draw them to management's attention. They may then be corrected prior to publication of the financial statements.

(iii) *Reporting control:* If the auditor detects material errors in the financial statements and refers them to management, but management refuses to correct them, the auditor draws attention to the errors by qualifying the audit report (that is, the auditor states that all is not well, giving reasons for this conclusion). In this way, users of the financial statements are made aware that, in the auditor's opinion, the information provided is not reliable.

It is interesting to note that, while UK legislation is silent on the qualifications of those who may prepare company financial statements, the Companies Act 1989 specifies that the auditor of these statements must hold an 'appropriate qualification' and be 'registered'.[12] This implies that, although the preparer of

[12] The required qualifications and registration of auditors is discussed in Chapter 5.

the financial statements need not be a qualified accountant, the auditor must be a well-qualified, competent and experienced professional. It therefore seems that Parliament looks to auditors to protect the interests of financial statement users by giving assurance that the financial statements are reliable, or providing a warning that they are not.

1.6.2 Auditees

During the course of an external financial statement audit, the auditor becomes very familiar with the organisation, its business, its accounting system and all aspects of its financial affairs. Added to this, the auditor is a qualified and experienced individual, who comes to the auditee as an independent objective outsider, divorced from the day-to-day running of the entity.

These factors place the auditor in an ideal position to observe where improvements can be made. (S)he is able to advise the auditee on matters such as strengthening internal control; the development of accounting or other management information systems; and tax, investment and financial planning. In addition (in cases where the issue arises for the auditee), the auditor is able to provide advice on matters such as how to proceed with a share float, businesses acquisition or divestment, or liquidation. The provision of these 'additional services' by the auditor is very valuable for the auditee. Indeed, as Anderson (1977) pointed out:

> In many cases, it is the presence of these collateral services which makes the audit an economical package from management's point of view. The professional auditor must always be alert for opportunities to be of service to his or her client while at the same time discharging conscientiously his or her responsibilities to the users of the audited financial statements. (p. 6)

Notwithstanding the value of these services for the auditee, there is a potential danger which auditors need to bear in mind. In recent years, the fees paid by audit clients to their auditors for non-audit services have grown to such an extent that in many instances, as indicated in Figure 1.1, they exceed the audit fee. This has led to concerns that auditors may not be sufficiently critical in their auditing duties for fear of upsetting the entity's management and consequently losing lucrative non-audit contracts.[13]

1.6.3 Society as a whole

The benefits flowing from audits for society as a whole fall into two broad groups:

(i) those relating to the smooth functioning of financial markets; and
(ii) those relating to securing the accountability of corporate managements.

[13] The dangers to auditors' independence of providing non-audit services to audit clients is discussed in Chapter 4.

(i) Smooth functioning of financial markets

The benefits – and importance – of audits helping to ensure the smooth functioning of financial markets was aptly conveyed by Turner (2001), Chief Accountant of the Securities and Exchange Commission in the United States of America (USA), when he stated:

> The enduring confidence of the investing public in the integrity of our capital markets is vital. In America today, approximately one out of every two adults has invested their savings in the securities markets, either [directly] through the purchase of individual stocks or [indirectly through investment] in a mutual fund or . . . pension plan. . . . These investments have provided trillions of dollars in capital for companies in the United States and around the globe. That capital is providing the fuel for our economic engine, funding for the growth of new businesses, and providing . . . job opportunities for tens of millions of workers. But . . . the willingness of investors to continue to invest their money in the markets cannot be taken for granted. . . . Public trust begins, and ends, with the integrity of the numbers the public uses to form the basis for making their investment decisions. . . . Accordingly, investors in the U.S. capital markets have depended for over a hundred years on an independent third party, an external auditor to examine the book and financial reports prepared by management. (pp. 1–2)

Thus, in the USA – and similarly in the UK and other countries throughout the Western world – continued investment in the capital markets is essential to the well-being of the economy – and to the financial well-being of those who invest directly or indirectly in the financial markets. Continued investment in the financial markets rests on investors having confidence in the financial information on which they base their investment decisions. This confidence, in turn, is derived from the audit function. Although not referred to by Turner, indirect investment includes investment by local authorities, and other public sector bodies, of funds (derived in the form of taxes but not yet needed to meet expenditures) provided by the vast majority of the public. Therefore, most members of society – directly or indirectly – benefit from external financial statement audits.

(ii) Securing the accountability of corporate managements

Over the last 160 or so years, as financial, human and other non-financial resources have been channelled by individuals and groups in society to companies, so these entities have grown in size. As they have become larger, they have gained significant social, economic and political power. Today, large national and multinational companies dominate the lives, and control the well-being, of whole communities and have a major impact on society in general. However, in a democratic society, power is not absolute. Mindful of Lord Acton's dictum that 'power corrupts and absolute power corrupts absolutely', society has set in place checks and balances designed to prevent possible abuse of power. As one of the checks designed to ensure that company managements do not abuse the power bestowed upon them through the provision of resources, they are held accountable for the responsible use of the resources entrusted to them. This accountability is secured primarily by requiring company directors:

- to provide publicly available annual financial statements which report on their use of resources;
- to submit these financial statements to a critical examination by an independent expert (that is, an audit).

Thus, auditors may be seen as an integral part of the process of securing the accountability of company managements who control and use the resources of various groups in society such as shareholders, debt-holders, creditors, employees, suppliers, customers and the general public. Legally, a company auditor is appointed by, and reports to, shareholders. In reality, however, all stakeholders who provide resources to company managements (or who are otherwise affected by company managements' decisions) have an interest in the accountability process of which auditing is a part.

Therefore, in addition to protecting the interests of financial statement users by giving credibility to the financial statements, and providing ancillary services to auditee entities, the external audit, by helping to ensure the smooth functioning of financial markets, and by functioning as an element of social control within the corporate accountability process, is also of value to society as a whole.

1.7 SUMMARY

In this chapter we have considered the nature of the audit function and distinguished between financial statement audits, compliance audits and operational audits, and between external and internal audits. We have also noted the difference between accounting and auditing and discussed why external financial statement audits are needed. In the final section of the chapter we examined some of the benefits derived from these audits by financial statement users, auditees, and society as a whole.

In the next chapter we trace the development of auditing, noting in particular how auditing has responded over time to changes in its socio-economic environment.

SELF-REVIEW QUESTIONS

1.1 Give a comprehensive definition of auditing.

1.2 Explain briefly the following words and phrases included in the definition of auditing given in this chapter:

(i) systematic process
(ii) objectively gathering and evaluating evidence
(iii) assertions
(iv) degree of correspondence between assertions and established criteria
(v) communicating the results.

1.3 List the major elements which are present in all audits.

1.4 Explain briefly the major differences between the following types of audits:
(i) Financial statement audits
(ii) Compliance audits
(iii) Operational audits.

1.5 Under the provisions of the Companies Act 1985 an auditor's report must be attached to a company's financial statements. Is this true for all companies? Explain.

1.6 Distinguish between:
(i) auditing and accounting; and
(ii) internal and external audits.

1.7 Explain briefly why external financial statement audits are needed.

1.8 It is said that the value of an audit for financial statement users lies in the credibility it gives to the financial statements which are prepared by management. Explain briefly the three types of control which help an audit to give credibility to audited financial statements.

1.9 Explain briefly the benefits which an external financial statement audit provides for an auditee. Also explain any dangers which may result from auditors providing 'additional services' to auditees.

1.10 Explain briefly the value of external financial statement audits for society as a whole.

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